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UNCLAS SECTION 01 OF 03 SAO PAULO 000680

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STATE PASS EXIMBANK
STATE PASS OPIC FOR DMORONSE, NRIVERA, CMERVENNE
DEPT OF TREASURY FOR JHOEK, BONEILL

E.O. 12958: N/A
TAGS: ECON EFIN EINV ETRD BR
SUBJECT: BRAZIL'S BUSINESS OUTLOOK FOR 2009 NOT GOOD

SENSITIVE BUT UNCLASSIFIED--PLEASE PROTECT ACCORDINGLY

¶1. (SBU) Summary: Despite Brazil's impressive September economic performance, most of the domestic indicators show that 2009 will be a difficult year. Contacts across Brazilian business sectors told the Consul General that they are preparing for difficult times in ¶2009. Early indicators of consumer goods sales and industrial production point to softening fourth quarter growth and indicate a slide into a much weaker 2009 economic performance. In particular, the auto industry has been hard hit in Brazil. This will reverberate back to the United States as Brazilian auto sales had led profitability indicators for many U.S. auto manufacturers. Consensus expectations for Brazilian economic indicators are rapidly declining, with GDP growth in 2009 expected at only 2.5 percent compared with 5.7 percent in 2007 and an expected 6 percent in 2008. With tax revenues declining due to slumping production and slowing consumption, the GOB will need to balance fiscal stimulus measures to boost the economy while keeping overall spending under control. End Summary.

Growth On Track Through September

¶2. (U) The Brazilian economy had a record performance in the third quarter, with growth up 6.8 percent over the same period in 2007. With the most recent numbers, Brazil is on the path for approximately six percent GDP growth in 2008. Private consumption, investments, and government expenditures were the drivers for this impressive jump in GDP. Domestic demand contributed about 10 percentage points to the overall output growth, while net exports again were a negative drain on the economy of nearly three percentage points.

But Will Not Continue

¶3. (U) Despite the surprisingly positive numbers through September, most of the indicators for domestic performance suggest this trend will not continue into the last quarter. October retail sales plummeted, down eight percent from September. Vehicle sales alone are down 25 percent from November 2007 numbers and consumption and energy usage are showing anemic, marginal growth. At the same time that domestic production and consumption have decreased, private investment is showing signs of weakening because of declining business confidence and a lack of liquidity from both domestic and

international sources. Indeed, foreign direct investment in November was down 14 percent from last year.

¶4. (SBU) In a recent meeting with the Consul General, several Sao Paulo business leaders underscored the "doom and gloom" ahead despite the record third quarter growth. Motorola executives told the CG that they were expecting a grim 2009. The currency depreciation has shocked them and they were forced to sacrifice their margins. Despite this, they still expect a five to 10 percent drop in cell phone sales in Latin America for 2009. GE said that the company's longer production cycle has helped their performance, but they expect a slowdown in late 2009. Caterpillar, though still positive, believes tough times are ahead. Orders are down 15 percent for 2009 across business units, and it has modified its budget to include a higher exchange rate of 2.38 Reals to the USD. The depreciation of the Real has made their export business more attractive and they expect significant increases in export of heavy machinery for 2009. 3M said that its auto parts division was starting to show signs of weakness, but that overall sales were up 20 percent over last year.

¶5. (SBU) Sectors that include basic goods have not yet seen the effects of the crisis, but told the CG they expect a slowdown by mid-2009. Colgate said that its sales so far have been positive or stable. International Paper had record sales in October due to school supplies and that 2008 sales were up by five percent. Despite this, investments in paper are being postponed and demand for pulp is down significantly. U.S. sales are down six percent in the fourth quarter over last year. Eli Lilly said its sales had been strong because the GOB was concerned about the health budget and had been building inventory in its high-end products.

¶6. (U) Even the large Brazilian multinationals have started showing signs of weakness. Brazilian industrial production in October slid 1.7 percent compared to September, and Itau Bank estimates November numbers will be down some five percent over last year. Embraer announced it would cut new aircraft deliveries from 315 to 270 units in 2009. Company officials refuted press reports that it is preparing to fire 4,000 employees, but did not rule out possible workforce cuts. One of Embraer's suppliers, Grauna Aerospace, manufacturer of precision parts, let go 10 percent of its 500 employees last week. Vale cut 2.1 percent of its workforce because of slumping global demand, five weeks after announcing a nine percent iron ore production cut. In a survey conducted November 6 to 14 by the National Chamber of Industries (CNI), 88 percent of Brazilian industrial firms surveyed responded that the global economic crisis is starting to directly affect their businesses. The most significant effect is a decline in demand, followed by higher machine costs, and tighter credit conditions. Seventy-one percent of firms reported that they have already reduced their 2009 investment budgets. Forty-nine percent of firms believe the economic crisis will be fully resolved in 2009, while 40 percent believe it will continue until 2010.

U.S. Automakers Hit Hard

¶7. (U) The effects of the crisis are clearly being felt strongly in the auto sector. After the three big U.S. auto manufacturers redoubled efforts to ramp up production in Brazil, adding extra shifts, thousands of workers, and millions of dollars in new investments in 2007 and 2008, production has slowed sharply. As credit for auto loans dried up in October, it became more expensive to secure auto loans. Dealers that previously offered six-year financing with no down payment are now asking for 50 percent down and financing over a two-year period. Ivan Favarin, a sales manager at a GM dealership in a middle-class neighborhood of Sao Paulo said that the uncertainty about the future economic situation has reduced demand for new cars as well. (Note: The GOB recently moved to reduce and in some cases eliminate certain industrial product excise taxes including for vehicles in an effort to spur consumption. Post will monitor this as it develops and report septel concerning its impacts. End Note.) Manufacturers have put many of their workers on mandatory vacation to idle assembly lines as stocks of unsold new

cars began climbing. Layoffs are also in the works as Volvo, a Ford subsidiary, became the first to announce layoffs, cutting 430 workers from a plant in Curitiba, about 18 percent of its workforce in Brazil. GM has started offering new retirement incentives as well.

Comment

¶8. (SBU) The effects of the global financial crisis are starting to permeate the Brazilian business community as even those sectors thought to be relatively immune from the crisis are showing signs of weakening demand. Consensus expectations in Brazil are rapidly declining across all indicators. Despite the consensus GDP growth of 5.2 percent (and perhaps up to six percent) this year, the financial community is preparing for a rapid deceleration in GDP growth to some 2.5 percent next year. Fourth quarter data in Brazil is likely to show the more pronounced effects of the crisis and will begin to clarify the impacts of the crisis for Brazil's economy going into 2009. Government receipts are already slowing due to slumping production and demand. With lower GDP growth expected next year, the GOB will have to tighten the purse strings to keep its fiscal accounts in order or move the target for the primary surplus. The Central Bank will face enormous pressure to cut interest rates January 20 when the year-end economic indicators start to show a real economic decline. (Note: The Central Bank kept interest rates steady at 13.75 percent on December 10 largely due to concerns over inflation, but foreshadowed cuts in January that many expect could be as great as 0.75 percentage points. End Note.) Though Brazil is well positioned to fight off the crisis due to large international reserves (including USD 150 billion in U.S. Treasury bills-the world's fourth largest holder of these instruments) and relatively more liquid banking sector, all indicators are predicting a

difficult year in 2009. On the political front, the Lula Administration will have to fight to shield itself from blame and the opposition parties appear to be gearing up to do just that. End Comment.

¶9. (U) This cable was coordinated/cleared by Embassy Brasilia and the U.S. Treasury Financial Attach in Sao Paulo.

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